Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:NED:BOS:TL-N-2251-00
MJGormley

date:

to: District Director, New England District
Attn: [redacted]

from: District Counsel, New England District, Boston

subject: [redacted]
Canadian Income Tax Treaty
U.I.L.# 864.02-07 Property Formerly Used in U.S. Business
882.00-00 Tax on Income of Foreign Corporations with U.S. Business
7852.01-00 Construction of Laws
871.03-00 U.S. Trade or Business v. no U.S. Trade or Business

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ISSUES

1. In a conflict between I.R.C. § 864(c)(7) and the US-Canadian Income Tax Treaty pertaining to the taxability of income from a

foreign taxpayer's permanent establishment in the United States, which authority controls, the Code or the Treaty?

2. If the Treaty is found to be the controlling authority, which provisions of the Treaty apply?

CONCLUSION

In the conflict between the Treaty and Internal Revenue Code § 864(c)(7), the Treaty prevails. Applying the terms of the Treaty to the facts of this case, Article XIII of the Treaty controls. Finally, in interpreting the provisions of Article XIII, gain is determined as of the date of sale of the property if the sale takes place within twelve months of the date the property is removed from the permanent establishment. It is not necessary for the permanent establishment to terminate.

FACTS

This memorandum is written in response to your request for advice regarding taxpayer's reporting of sales of personal property on their [redacted], [redacted] and [redacted] income tax returns. The advice requested pertains to a conflict between I.R.C. § 864(c)(7) and the U.S. - Canadian Income Tax Treaty. You are seeking our advice regarding which applies, the Internal Revenue Code or the Treaty and further, if the Treaty applies, you are questioning which provisions of the Treaty apply. Finally, you have sought our advice regarding the proper interpretation of certain provisions of the Treaty.

The taxpayer, [redacted] is a mutual life insurance company organized in Canada in [redacted] It has conducted an insurance business in the United States through a U.S. branch for over [redacted] years. On occasion, the taxpayer has removed securities from its U.S. branch and sold this property to unrelated parties within [redacted] ([redacted]) years of the date of its removal. The taxpayer has initially reported gain on these sales as taxable income on its federal income tax return for the year of sale, [redacted], relying on I.R.C. § 864(c)(7). Thereafter, the taxpayer filed its income tax returns for the years [redacted] and [redacted] relying on Article VII of the United States - Canadian Income Tax Treaty of September 26, 1980. Under this Article of the Treaty, the taxpayer determined gain as of the date the securities were removed from the permanent establishment. Taxpayer has since taken the position that the gain from these sales has been reported in error. The taxpayer now claims that Article XIII of the U.S. - Canadian Income Tax Treaty applies and prohibits the taxation of these sales. Taxpayer has requested an adjustment, reducing reported gains by $[redacted] in [redacted] The [redacted] year is pending in the [redacted] Appeals Office. The [redacted] and [redacted] years are still pending in Examination.[1]

LEGAL ANALYSIS

Taxpayer, as a branch of a foreign insurance company carrying on an insurance business within the U.S., is taxable on its income that is effectively connected with the conduct of any trade or business within the United States. I.R.C. § 842(a). Regular U.S. tax rates apply to all such effectively connected income. I.R.C. § 842(c). Generally, I.R.C. § 882 provides for the determination of the foreign corporation's taxable income, taxing the foreign corporation on income that is effectively connected with a U.S. trade or business. Here, however, in determining whether income of a foreign life insurance company is effectively connected with the conduct of a U.S. business, the annual statement of its U.S. business on the form approved by the National Association of Insurance Commissioners will usually be followed. See S. Rep. No. 1707, 89th Cong. 2d Sess., 38 (1966), P.L. 89-809 Committee Report. Foreign life companies place assets pledged to support U.S. business in trust and may move these assets in and out of trust during the year and replace them with other assets, provided the total assets remain sufficient to support U.S. business. For the period the asset is "trusted", the income is reported on the annual statement and is effectively connected. In the present case, the stock that is the subject of your examination was moved out of trusted status in [redacted]. As such, the gain from the sale of this stock was not effectively connected for the years at issue.

U.S. source income that is not effectively connected is subject to a 30% tax rate or lower treaty tax rate. I.R.C. § 881. Although the income at issue herein would be treated as not effectively connected because it was not listed on the annual statement, I.R.C. § 864(c)(1)(A) provides an exception. Here, if a foreign corporation is engaged in a trade or business in the U.S. within the year, the rules of I.R.C. § 864(c)(7) will apply in determining the income, gain or loss that will be treated as effectively connected. Subparagraph (7)(A) of I.R.C. § 864(c), provides that if any property ceases to be used or held for use in connection with the conduct of a trade or business within the U.S., and such property is disposed of within 10 years after such cessation, the determination of whether the income will be treated as effectively connected under I.R.C. § 882 will be made

[1] The taxpayer has since abandoned it reliance on Article VII and is now taking the position that Article XIII of the Treaty applies in all years, including [redacted] and [redacted].

as if the sale or exchange occurred immediately before the cessation and without regard to the requirement that the taxpayer be engaged in a trade or business in the U.S. The parties are in agreement that if I.R.C. § 864 (c) applied, gain would be determined as of the date of sale, if such sale occurred within ten years of the time the property ceased to be used in the U.S. trade or business.

In our case, however, the situation is complicated by the U.S. - Canadian Tax Treaty. At issue is whether the Treaty is applicable to this taxpayer and, if it is applicable, the correct interpretation of the Treaty Articles. Initially, the taxpayer took the position that Article VII of the Treaty applied. This Article provides that the business profits of the taxpayer are taxable only in Canada unless the taxpayer carries on business in the United States through a permanent establishment[2] situated in the U.S. If the taxpayer does carry on business in the U.S. through a permanent establishment in the U.S., the Treaty goes on to state that the taxpayer's business profits may be taxed in the U.S., but only so much of them as are attributable to that permanent establishment. Article VII, par. 1. The taxpayer took the position that Article VII applied and gain was to be determined as of the date the property was removed from the U.S. trade or business, regardless of the date the property is sold.[3]

Taxpayer has however, changed its position and maintains that Article XIII of the Treaty is applicable in lieu of Article VII. The Examination Team agrees that Article XIII applies; however, the Team disagree with the taxpayer's interpretation of the meaning of this Article. The taxpayer has taken the position that this portion of the Treaty applies, with the result that the taxpayer realizes a [redacted] gain on the sale of its property. This paragraph provides:

> Gains from the alienation of personal property forming part of the business property of a permanent establishment which a resident of a Contracting State [Canada] has or had (within the twelve-month period preceding the date of alienation) in the other Contracting State [U.S.] ..., including such gains from the alienation of such a permanent

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[2] Treaties uniformly refer to a permanent establishment whereas the Code refers to a trade or business. <u>See generally</u> Rhoades and Langer U.S. International Taxation and Tax Treaties, Part III. Analysis of U.S. Income Tax Treaties, Chapter 44. Permanent Establishments.

[3] This was the taxpayer's treaty-based return position as disclosed on Form 8833 for tax years [redacted] and [redacted].

establishment ... may be taxed in that other State [U.S.]

Based in its interpretation of paragraph 2., of Article XIII, taxpayer argues that in order for the asset to be subject to tax once it is removed from the permanent establishment under this Article, the permanent establishment itself must terminate. Under the Examination Team's interpretation, this Article changes only the window for monitoring dispositions of personal property that have been removed from a permanent establishment: the ten year window under I.R.C. § 864(c) is changed to twelve-months under the provisions of the Treaty. Gain is determined as of the date of sale of the property if the sale takes place within twelve months of the date the property is removed from the permanent establishment. Under their interpretation, it is not necessary for the permanent establishment to terminate.

Initially, a determination must be made as to whether the Treaty or the Internal Revenue Code applies. The supremacy clause of the U.S. Constitution deals with the relationship between treaties and laws. It provides:

> This Constitution, and the laws of the United States which shall be made in pursuance thereof; and all treaties made, or which shall be made, under the authority of the United States, shall be the supreme law of the land....

Accordingly, income tax treaties are the supreme law of the land. As such, if the terms of a treaty conflict with a state law, the treaty controls. If the treaty conflicts with another treaty or a federal statute, whichever was most recently adopted generally controls. See Reid v. Covert, 354 U.S. 1 (1956). However, in order for a later statute to prevail over a previously adopted treaty, Congress must clearly identify its intentions. See Cook v. U.S., 288 U.S. 102 (1933).

Prior to the Tax Reform Act of 1986, treaties generally overrode conflicting Code provisions. This was a required result under I.R.C. §7852(d), Treaty Obligations, which dealt directly with the application of income tax treaties and applied to any treaty in effect on August 16, 1954, the date the Code was enacted. The Tax Reform Act of 1986 contained several provisions in which the Code specifically overrode treaties. Thereafter, in 1988, TAMRA amended I.R.C. § 7852(d).[4] TAMRA provided that except for certain pre-1954 Code situations, provisions of a treaty and those of a law have equal status, neither having

[4] See Technical and Miscellaneous Revenue Act of 1988, P.L. 100-647 § 1012 (aa)(1)(A).

preference over the other.[5]

However, in enacting this new legislation, Congress expressed its intent that in certain circumstances, nothing contained in the new law was intended to override any treaty obligation. TAMRA provided that ten amendments made by the 1986 Act, as amended by TAMRA's technical corrections, did not apply to the extent they were contrary to any treaty obligation in effect on October 22, 1986. See P.L. 100-647 Sec. 1012(aa)(3)(H), 26 USC 861 note., 101 Stat. 3531. See generally Rhoades and Langer U.S. International Taxation and Tax Treaties, Part III. Analysis of U.S. Income Tax Treaties, Chapter 43, section .06, TAMRA's Impact on the Relationship Between Treaties and the Code. One of these amendments is related to effectively connected gains and is directly applicable to this case. Specifically, the 1986 Act added I.R.C. § 864(c)(7)which provided:

> For purposes of this Title, if any property ceases to be used or held for use in connection with the conduct of a trade or business within the United States, the determination of whether any income or gain attributable to a sale or exchange of such property occurring within 10 years after such cessation is effectively connected with the conduct of a trade or business within the United States shall be made as if such sale or exchange occurred immediately before such cessation.

Pub. L. 99-514, § 1242(a).

The ten year period specified in I.R.C. § 864(c)(7), as amended by TAMRA, is in conflict with the 12 month period specified in Article XIII of the Treaty. Given this conflict, in accordance with section 1012(aa)(3)(H), the Treaty prevails. See generally Rhoades and Langer U.S. International Taxation and Tax Treaties, Part III. Analysis of U.S. Income Tax Treaties, Chapter 43. Treaty Overrides - Treaties versus the Code (Matthew Bender & Co., Inc.).

Once the determination is made that the Treaty applies, the provisions of the Treaty must still be interpreted. Income tax treaties are subject to judicial interpretation in much the same manner as the Code. Interpretation begins with the language of the Treaty itself. See Sumitomo Shoji America, Inc. v. Avagliano, 457 U.S. 176, 180 (1982). The "clear language of the treaty controls unless 'application of the words of the treaty

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[5] Prior to the amendment, § 7852 clearly gave a Treaty priority. P.L. 100-647 § 1012 (r)(1)

according to their obvious meaning effects a result inconsistent with the intent or expectations of its signatories.'" Id. quoting Maximov v. U.S., 373 U.S. 49, 54 (1963). Words are to be taken at their ordinary meaning. Geofroy v. Riggs, 133 U.S. 258, 271 (1890). If it is necessary to go behind the language of the treaty itself, legislative history is an important resource in treaty construction. It generally includes of State Department Reports, Senate Foreign Relations Committee Hearings and Reports, Joint Committee on Taxation Memorandum, and Treasury Department Technical Explanations. See Rhoades and Langer U.S. International Taxation and Tax Treaties, Part III. Analysis of U.S. Income Tax Treaties, Chapter 41. How Income Tax Treaties Work, Section .04, Interpretation of Treaties; Legislative History.

This then brings us to Article XIII of the Treaty. As noted, the parties disagree as to the proper interpretation of this Article. Both a reading of the plain language of the Treaty provision and the legislative history of the Treaty support the Examination Team's interpretation of Article XIII. In paragraph 2. of Article XIII, the section provides that gain from the alienation of personal property forming part of the business property of a permanent establishment which a resident of Canada *has or has had* within the twelve month period preceding the date of alienation in the U.S., *including* gain from the alienation of the permanent establishment, may be taxed in the U.S. (Emphasis added). Here, the language of the Article itself is clear. It applies to a permanent establishment that either is or was in existence within the twelve months prior to alienation. If alienation of the permanent establishment itself was a prerequisite to taxability, only the past tense "has had" would have been utilized in the language of the paragraph. Additionally, the language in the last portion of the paragraph is inclusive rather than limiting or exclusive when it refers to the alienation of the permanent establishment: "...including ...gain from the alienation of such permanent establishment...". As noted, in construing treaties, words are to be taken at their ordinary meaning. In doing so, a plain reading of the Treaty supports the conclusion that it is not necessary for the permanent establishment to terminate in order for gains from the sale (alienation) of personal property to be taxable in the U.S.

The legislative history of the Treaty also supports this interpretation. In an explanation of the Treaty prepared by the staff of the Joint Committee on Taxation[6] , it is noted:

[6] Explanation of Proposed Income Tax Treaty (and Proposed Protocols) between the United States and Canada Scheduled for

> Under the language of the proposed treaty, gains derived by a resident of one country from the disposition of ...personal property which forms a part of the business property of a permanent establishment or a fixed base *(including gains on the disposition of the permanent establishment or the fixed base itself)* may be taxed in the country where the permanent establishment or fixed base is located. For this purpose, a permanent establishment includes a permanent establishment that existed within the last twelve months prior to the disposition of the property. Emphasis added.

The parenthetical included in the Staff's Explanation adds further support to an inclusive reading of the latter part of the paragraph. The taxable gains include either gains from the sale (alienation) of the personal property or the permanent establishment itself.[7]

CONCLUSION

As noted above, given the specific facts of this case, in the conflict between the Treaty and Internal Revenue Code § 864(c)(7), the Treaty prevails. In applying the terms of the Treaty to the facts of this case, Article XIII controls. Finally, in interpreting the provisions of Article XIII, gain is determined as of the date of sale of the property if the sale takes place within twelve months of the date the property is removed from the permanent establishment. It is not necessary for the permanent establishment to terminate.

If you have any questions regarding this matter, please contact the undersigned at 617/565-7858.

Hearing Before the Committee on Foreign Relations United States Senate on April 26, 1984, prepared by the Staff of the Joint Committee on Taxation April 25, 1984, Published 25 Apr 84, 85 TNI 37-31.

[7] See also Treasury Department Technical Explanation of Convention Between the United States and Canada with Respect to Taxes on Income and on Capital signed at Washington D.C. on September 26, 1980, as amended by the Protocol signed at Ottawa on June 14, 1983 and the Protocol signed at Washington on March 28, 1984, Published 23 Apr 84 (Final Revision). 85 TNI 37-33.

MAUREEN T. O'BRIEN
Assistant District Counsel

By: ______________________________
MICHELE J. GORMLEY
Senior Attorney

cc: Michael Corrado
Assistant Regional Counsel (TL)
Northeast Region